



# International Economic Trends

February 2006



## The Dollar U-Turn

**A**lthough the United States has run current account deficits since 1990, those deficits have recently assumed extraordinary proportions. Between 2004:Q4 and 2005:Q3, the U.S. external deficit has averaged 6.4 percent of GDP. A current account deficit is the difference between a country's imports of goods and services and the sum of its exports and net factor payments. Although other macroeconomic factors affect exchange rates (e.g., differential interest and growth rates), many economists have suggested that, in the presence of large current account deficits, the dollar will depreciate. As the dollar depreciates, the dollar price of foreign goods and services increases, while the price abroad (in foreign currency) of U.S. goods and services declines. As a result, U.S. households and firms buy fewer imported goods, while foreign households and firms purchase more U.S. goods. Therefore a depreciating dollar ought to bring the current account back toward neutral.<sup>1</sup>

The chart shows that over the period 2002-04 the real effective value of the U.S. dollar has depreciated at an average pace of 4.7 percent per annum. This tendency reversed in 2005; the real value of the dollar appreciated by 3.6 percent last year. Many commentators have expressed concerns about the incompatibility between the dollar U-turn and the current account deficit, predicting dollar depreciation in 2006.

Why has the dollar appreciated despite the very large U.S. current account deficit? One factor is that, over the period 2004-05, the monetary authorities of a number of developing countries—mostly in Asia—purchased 269 billion in U.S. dollar securities. China alone has seen its U.S. dollar reserves grow by \$167 billion, to exceed \$800 billion.<sup>2</sup>

These Asian governments oppose an uncontrolled dollar depreciation for two reasons: (i) Their huge dollar-denominated reserves expose them to enormous losses if the dollar depreciates significantly. A 20 percent dollar depreciation, for example, would reduce Chinese reserves by an amount between 2 and 9 percent of the Chinese GDP and reduce Singapore's reserves

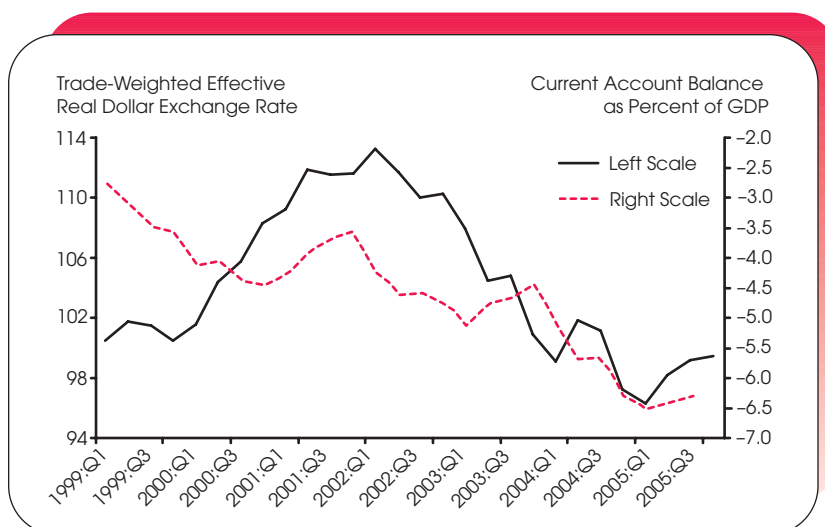
by between 18 and 25 percent of its GDP. (ii) Uncontrolled growth of foreign reserves can also cause an excessive expansion of domestic liquidity, which poses inflation risks.

As a result, many U.S. trading partners have resisted the weakening dollar and welcomed 2005 as a break to an unsustainable trend. A number of Asian countries still need to implement institutional reforms to prepare them for domestically driven growth and end their dependence on export surpluses supported by weak currencies. In July 2005, China took a step in this direction by revaluing the renminbi's parity with the dollar by 2.1 percent and simultaneously switching from a dollar peg to a managed floating regime in which the parity is determined with reference to a basket of currencies. The Chinese are implementing other structural reforms to increase the efficiency of currency markets and to enable all firms to hedge currency risks. This seems to herald further reforms that might re-establish more symmetry in international trade relationships. If developing Asian economies will persist on the reforming path, in the long-run the dollar may not have to bear the entire burden of much needed adjustments in international current accounts.

—Massimo Guidolin

<sup>1</sup> Blanchard, O., Giavazzi, F., and Sa, F., 2005, "The U.S. Current Account and the Dollar", NBER Working Paper No. W11137.

<sup>2</sup> Source: International Monetary Fund.



Views expressed do not necessarily reflect official positions of the Federal Reserve System.